

Internal Revenue Service

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PLR-157716-06

Draft Date:
April 16, 2007

LEGEND:

X =

Parent =

State 1 =

State 2 =

State 2 Law =

Dear :

This is in response to a letter dated October 16, 2006, and subsequent correspondence submitted by X, requesting a ruling that the income of X is excludable from gross income under section 115(1) of the Internal Revenue Code (Code).

FACTS

X is a captive insurance company organized under the laws of State 1. X was organized as a nonprofit corporation for the purpose of providing excess insurance coverage to its sole member, Parent. Parent was established pursuant to State 2 Law as a public agency, joint powers authority. Parent is a joint self-insurance pool, whose income taxpayer represents is excludable from gross income under section 115 and which provides risk-management services and coverage to its members. Members of Parent consist exclusively of State 2 school districts and community colleges (Member Schools).

X is governed by a board of directors composed of employees of either Parent or the Member Schools, except as otherwise required by State 1's captive insurance code. All the funds necessary for the initial capitalization of X, as well as the purchase of reinsurance policies and payment of operating and administrative expenses, are

provided by Parent. X's income will be used to cover its administrative expenses and cover the losses of Parent.

X's restated articles of incorporation require that X's assets and income accrue only to the benefit of Parent, or if Parent ceases to exist or to qualify as an entity that may exclude its income from gross income under section 115 of the Code, to a State, political subdivision thereof, or an entity whose income is excludable from gross income under section 115 of the Code. Moreover, upon dissolution, all of X's assets must be distributed only to Parent, or if Parent ceases to exist or to qualify as an entity that may exclude its income from gross income under section 115 of the Code, a State, political subdivision thereof, or an entity whose income is excludable from gross income under section 115 of the Code.

LAW and ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or a political subdivision of a state.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from a fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its political subdivisions, is excludable from gross income under section 115. The ruling explains that the investment of positive cash balances by a state or political subdivision thereof in order to receive yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes or other revenue for use in meeting governmental expenses. In addition, the ruling also provides that because the state and its participating political subdivisions have an unrestricted right to their proportionate share of the investment fund's income, the fund's income accrues to them within the meaning of section 115(1). Rev. Rul. 77-261 points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct.

Rev. Rul. 90-74, 1990-2 C.B. 34, holds that income of an organization formed, operated and funded by political subdivisions of a state to pool their casualty risks is excluded from gross income under section 115(1). The ruling also holds that income of such an organization formed to pool risks in lieu of purchasing insurance to cover their public liability, workers' compensation, or employees' health obligations is excluded under section 115(1) if private interests do not, except for incidental benefits to employees of the participating state and political subdivisions, participate in or benefit from the organizations.

Parent may take steps to protect its financial security. X was created to provide excess insurance coverage to Parent that is either unavailable or prohibitively expensive. Thus, X is performing an essential governmental function that is within the scope of section 115.

X's income will be used to provide benefits to its sole member, the Parent. In the event of the dissolution of X, all its remaining assets, after the payment of debts and obligations, shall be distributed to its Parent so long as Parent's income is excludable from gross income under section 115(1). If the Parent is no longer in existence or if its income is no longer excludable from gross income under section 115(1), the assets shall be distributed to a State, political subdivision thereof, or an entity whose income is excludable from gross income under Code section 115(1).

CONCLUSION

Based on the information and representations submitted by the taxpayer, we conclude that the income of X is excludible from gross income under section 115 (1) of the Code.

No opinion is expressed or implied as to the federal tax consequences of the arrangement described above under any other provision of the Code. Specifically, no opinion is expressed whether X is an instrumentality of a state or political subdivision for purposes of section 103. In addition, because we have concluded that section 115(1) is applicable to X, no determination has been made and no opinion is expressed whether X meets the definition of an insurance company under sections 1.801-3(a) and 1.831-1(a) of the Income Tax Regulations or within the meaning of section 816 or 831.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

David L. Marshall
Chief, Exempt Organizations Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:

Copy of this letter
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